Statement of
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Concerning the FHA Financial Statement Audit Report on Internal Controls and HUD 2020 Management Reforms

Chairman Mack and Members of the Subcommittee, I appreciate the opportunity to appear before you today to discuss aspects of the oversight of the Federal Housing Administration (FHA) and recent plans to revise various FHA operational methods. KPMG Peat Marwick has recently reported the results of their audit of FHA's fiscal year 1997 financial statements and I'd like to relate some of the identified weaknesses to the changes proposed through HUD's 2020 management reform efforts.

At the Subcommittee's May 7, 1998, hearing, you asked about the adequacy of internal controls and whether the Department is pursuing the right kind of actions as they undertake management reforms. GAO defines internal controls as " the plan of organization and methods and procedures adopted by management to ensure resource use is consistent with laws, regulations, and policies; that resources are safeguarded against waste, loss and misuse; and that reliable information is obtained, maintained, and fairly disclosed in reports". Most of the reform concepts we have seen under the HUD 2020 Management Reform Plan broadly address internal controls. At the last hearing, I mentioned HUD's plan to address the issue of the lack of income verification for subsidized tenants. But, merely having a plan doesn't correct the internal control problem. Not until the staffing and resources are put in place and working will the Department have successfully addressed this issue. Similarly, most other management reforms under HUD 2020 are in the very early stages of implementation and accordingly, we cannot assess the adequacy of the internal controls.

Resource Management

Resource management issues continue to be reported as a material weakness in the most recent financial statement audit report. Perhaps the most dramatic impact of the HUD 2020 Management Reform Plan are the personnel changes affecting nearly every employee in HUD. We are deeply concerned that HUD makes it through this transition period and ultimately places staff with the proper skills in positions in the "new HUD". For at least the last five years, our reports have continuously questioned the adequacy of staffing. HUD does not tie workload to staffing needs and consequently in many areas we found staff unable to perform assigned duties because of major workload imbalances. Partially in response to our concerns, in December 1997 the Department selected a contractor to review and analyze the staffing requirements of the new HUD. The contractor's final report issued in March concluded that a staffing level ranging between 7,400 and 8,100 would be adequate to carry out the Department's responsibilities under HUD's 2020 Management Reform Plan. However, a close look at the contractor's report makes it clear that the validity of this staffing level is contingent upon successful implementation of many complex activities to include: the new organizational structure, effective processes and systems, legislative program consolidations and the realization of the benefits of portfolio reengineering.

HUD staffing during the last year has been cut about 15 percent to about 9,100 employees. Many HUD staff have been selected for new positions in the various Hubs and Centers but continue in their old jobs until the many administrative details of the reorganization are worked out. Other staff, such as those unassigned, are carrying out other duties on an ad hoc basis. Some staff have been waiting for several months for their new assignments. During the transition, while the workload and work processes have generally not changed, there are fewer people to do the work. Consequently, as reported in our latest financial statement audit report, necessary work activities, such as property inspections and financial statement reviews, are not being done during the transition. Further, in some cases the Department is compensating for staff voids through contracting.

The biggest change in HUD's resource levels were made in HUD's single family housing program. In 1994, there were over 2700 HUD staff operating single family programs nationwide; by the end of 1999, the staffing level is projected to be at 759. This downsizing of Single Family staff reflects single family note sales and assumes use of rapidly changing technology, staff consolidations, and increasing reliance on the private sector to carry out many functions once performed by HUD staff.

Organizational reforms are taking place quickly and many staff are taking new assignments in different program areas. Many of the Centers are not fully staffed and the Department is still determining how to fill remaining vacancies. As single family downsizing is the most severe, they have the largest number of staff not placed. Workloads are being transferred among offices because of various staff imbalances as operational activities have changed locations. Some staff are performing duties outside of their area of expertise. Critical to this reform will be the need to have fully trained and competent staff to carry out activities. Untrained and under skilled staff add to HUD's vulnerabilities.

To address problems with resource management, the Department has contracted with NAPA to develop a resource estimation system. NAPA work has just started. They are currently putting together advisory groups to determine the type of system needed.

Inefficient staffing is exacerbated by the proliferation of new HUD programs without corresponding increases in staffing. In our December 1994 "Report on Opportunities for Terminating, Consolidating and Restructuring HUD Programs", we noted FHA administered about 80 programs and activities. A recent update showed that the number of programs and activities has increased to nearly 100. The sheer volume of the policies, procedures, and directives needed to operate these programs impacts on HUD's ability to focus on its mission. Resource issues become even more complex as dwindling staff resources are diverted to work on programs and activities that really are not essential to HUD's core mission.

We commend the Congress for its action three years ago in eliminating the Single Family Assignment Program. This program was shown to be staff intensive and costly to the insurance fund. There are other FHA programs that are risky and/or provide limited benefit as compared to their cost to operate. For example, we recommended the elimination of the 203(k) rehabilitation loan program for investor mortgages because of the risk of fraudulent activity. Also, we have proposed the elimination of the Title I program and the Hospital and Nursing Home Insurance Programs, as HUD serves such a small part of the market. Again, HUD needs to clearly define its business mission and focus attention on those activities that best meet that mission. In fact, HUD's mission is broadly defined as "empowering people and communities". To date, we have had limited success in our efforts to get HUD to narrow its focus on core mission areas.

Loss Mitigation and Monitoring

The financial audit recommends that FHA focus greater attention on reducing the frequency and loss severity of defaults on insured mortgages. In our audit of

HUD's consolidated financial statements, we noted similar concerns with the Office of Housing's ability to monitor assisted multifamily projects. HUD 2020 defines key initiatives aimed at improving HUD's monitoring of multifamily projects and reducing losses to the FHA fund. These include the Real Estate Assessment Center and contracting out the administration of Section 8 subsidy payments to contract administrators, such as State Housing Finance Agencies and PHAs. Pending the operation of the Real Estate Assessment Center, the Office of Housing has no mechanism to review financial statements or conduct inspections. When HUD 2020 reforms were initiated, the Office of Housing did not take actions to find a replacement financial statement review contractor and abandoned efforts to conduct physical inspections.

The Real Estate Assessment Center's plans at this point are still under development and implementation is contingent on HUD's ability to develop standard protocols for physical inspections and the submission of financial information. Moreover, HUD's efforts to contract out administration of subsidy payments is many months behind schedule and is further challenged by concerns expressed by the State Housing Finance Agencies with the legality of HUD's plan for Multi-State Administration of contracts. In our recently issued Semiannual Report to Congress we provide a list of critical steps that must be taken in the next 6 months for HUD to have a successful reform effort. The Real Estate Assessment Center protocols and the Section 8 contracting are two of these critical issues.

With respect to FHA's single family programs, all loss mitigation activities will be consolidated in the Oklahoma City Office. This function is only partially staffed and there is still uncertainty as to whether the planned staffing ceiling of 43 positions will be sufficient to handle all servicing and outreach functions. Currently, due to limited travel funds and insufficient staffing, the lender training and monitoring for loss mitigation that is needed cannot be done. Another potential problem the Department could face in the near future results from the recent court challenges over the termination of the Assignment program. If HUD is forced to return to the Assignment program, this could cripple FHA's operation.

Contracting Issues

Contracting is an integral element of the HUD 2020 Management Reform Plan. Many of the reported weaknesses are to be corrected through contracting out. While there is nothing inherently wrong with contracting out functions, it is essential that work performed by contractors is cost justified and adequately controlled. HUD's 2020 reforms provide for increased reliance on contractors to the point where HUD has already reduced staffing levels in anticipation of successfully turning over certain responsibilities to the private sector.

A major reform objective is to contract out the Real Estate Owned function. It is anticipated under HUD 2020 that HUD staff will not be needed to manage the property disposition function as structured in the past. A basic assumption of the plan is that the private sector can purchase HUD's pipeline of foreclosures and dispose of properties quicker and cheaper. Again, we are concerned that if privatization plans don't work as intended, HUD's options are limited, as there won't be HUD staff available to return to the old way of doing business.

A similar concern exists in regards to the Section 8 Financial Management Center. The presumption is that HUD will be moving from a retail to a wholesale method of managing the Section 8 portfolio. Contractors will be performing the Contract Administrator function once performed by the HUD staff. In turn a smaller cadre of contract monitors will be used to administer the contractors. HUD's new focus will be on contractor oversight. HUD's history of overseeing contracts and contractors has been dismal. We hope that HUD makes improvements to its current systems to make changes work. In response to our September 30, 1997 report on HUD Contracting, the Department has recently hired a Chief Procurement Officer (CPO). Further we are told that, plans are in place to establish a Contract Management Review Board which is intended to make major reform to the contract operations, and to establish a cadre of trained full time contracting specialists in HUD program offices. However, no official announcement has yet been made detailing the CPO's authorities, the CPO's placement within the organization, or the plans for the Contract Management Review Board, and the program contract specialists.

The National Academy of Public Administration is performing a detailed review of the HUD Procurement System. Their work to date has found serious deficiencies in the planning and management of the procurement workload and the skills and training of staff overseeing contractors. Their interim report echoes the concerns of this office, that is, top management must be committed to contract reforms for them to be successful.

Financial Systems and Role of the CIO

Reliable and accurate financial management systems will be critical to HUD's downsized environment. Results of our recent financial statement audit and other reviews have shown that system development has been problematic. Historically, HUD's systems were developed to meet the need of a specific user. Also, multiple inputs and limited edit checks often corrupted systems data. This was clearly evident in our recent audit of the 203(k) program where we found incorrect borrower data in the CHUMS system for a third of the loans we reviewed. The need for integrated systems became readily apparent when the same data varied in different systems. A huge Departmental effort is underway to "scrub data" in anticipation of an Integrated Financial Management System.

HUD has finally hired a Chief Information Officer (CIO), in compliance with the Information Technology Management Reform Act of 1996. However, HUD has yet to define the CIO's authorities, responsibilities, and placement within the organization. We believe that unless the CIO reports directly to the Secretary or the Deputy Secretary, and supervises the Information Technology Office, problems with HUD systems caused by organizational problems will remain.

Business and Operating Plan

Two weeks ago, the Secretary called together more than 400 staff in Washington to help put together the business and operating plans for the new HUD. There are many organizational changes which need to have responsibilities and protocols clarified. For example, how do the Homeownership Centers relate to the Real Estate Assessment Center or the Hubs. Each organization has been asked to prepare business and operating plans by the end of June for each organization in which they have a relationship. These business and operating plans are to provide an outline that links HUD's mission and business products to the needs of local communities and define how the various organizations will relate to one another. The plans will be formulated for each HUD office jurisdiction, reflect the products and services that HUD needs to deliver within a jurisdiction and establishes each jurisdiction's share of the work. With some of HUD's Centers serving a large number of jurisdictions, managing these plans could be a daunting task. For example, one Homeownership Center that services 24 office jurisdictions will need to be a part of 24 business and operating plans with each jurisdiction having different local needs and delivery systems.

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A common theme in everything discussed above are HUD's *plans* to correct outstanding problems. HUD's day to day operations have not radically changed since the announcement of the HUD 2020 Management Reform Plan. As mentioned earlier, most staffing changes have already taken place. Our Semiannual report as of March 31, 1998, makes it clear that the Department cannot continue in the planning stage. Some operations once performed, such as financial statement reviews and physical inspections, are suspended awaiting the planned reforms. HUD 2020 is a far-ranging and complex reform effort that lacked a sufficient analytic basis at the outset, and assumed that material weaknesses in HUD's infrastructure could be corrected at the same time that massive personnel and organizational changes were implemented. Not surprisingly, implementation of this effort has been slow. However, during this interim period, HUD's vulnerability to fraud and abuse is inevitably heightened.